

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Consumers Illinois Water Company	:	
	:	
Tariffs seeking general increase in water:	:	03-0403
rates for the Kankakee Water Division.	:	

**REPLY BRIEF ON EXCEPTIONS
OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION**

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NOW COMES the Staff of the Illinois Commerce Commission (“Staff”), through its undersigned counsel, pursuant to Section 200.830 of the Illinois Commerce Commission’s Rules of Practice (83 Ill. Adm. Code 200.830), and respectfully submits this Reply Brief on Exceptions responding to the Brief on Exceptions of Consumers Illinois Water Company (“CIWC” or “Company”) in the above referenced docket.

I. RATE BASE

A. Grant Park Acquisition

The Administrative Law Judge’s Proposed Order (“PO”) provides a well-reasoned conclusion in deciding to accept Staff’s proposed amounts for the addition of the Grant Park water system. The PO correctly points out that the Order in Docket No. 02-0480 directed the Company to file the actual journal entries within 6 months of the Order, thus recognizing that the journal entries that reflect the actual financial data at closing would need to be provided to the Commission. (PO, p. 6)

The PO correctly explains why accepting Staff's adjustment in this proceeding does not contradict the Order in Docket No. 02-480. As the PO explains, the ordering clauses allow for the approval of the accounting treatment sought by the Company and requires the Company to provide the actual journal entries after they become available. The PO complements the Order in Docket No. 02-0480; it does not revise or ignore that order as the Company contends. (CIWC BOE, p. 4)

The Company also argues that the PO ignores the journal entry that the Company made when acquiring Grant Park. The Company reasons that if the Commission did not expect the Company to make the journal entries reflected in Appendix C of the Order in Docket No. 02-0480 that it would have just required a list of accounts affected rather than the actual journal entries. (Id.) These arguments are not persuasive. If the Company made the wrong journal entries at the time of closing that does not somehow cause the conclusions reached by the PO in this proceeding to be incorrect. It only demonstrates that the Company needs to correct its entries. The Company's argument that the Commission would only ask for a list of accounts affected if it believed the Company would not make the entries as reflected in Appendix C of the Order in Docket No. 02-0480 fails on its face. The fact that the Commission required the Company to provide the actual journal entries at a later date not only provides for the possibility that the actual journal entries might reflect amounts different than the estimated ones, the Commission order demonstrates anticipation that the journal entries at a later date would be different.

The PO explains that the Company's symmetry arguments are unpersuasive. Nevertheless, the Company repeats them in its BOE. The Company argues that Staff's adjustment, accepted in the PO, is asymmetrical for two reasons: 1) Staff's adjustment does not allow for any increase in the utility plant in service between the date of the original cost study and the closing date; and 2) the accumulated depreciation would have to be synchronized with the depreciation expense collected in rates by the former owners of Grant Park's systems. In defense of its second symmetry argument, the Company points out that the record in the instant docket does not include the depreciation rates used nor the depreciation expense collected in rates by the Village of Grant Park, the former owners of the Grant Park water system. (Id.)

The first symmetry argument made by the Company is without merit. There is nothing in the record that suggests that the plant in service related to the Grant Park water system increased in original cost between October 1, 2001 and April 2003. The Company certainly did not enter any testimony in this proceeding that inferred as much. Furthermore, as stated in the first line of the PO's discussion of this topic, Staff's adjustment is proposed so that the Company's purchase of the Grant Park water system is reflected properly in rate base. (PO, p. 4) It is baseless to suggest that Staff's adjustment would not have included any substantiated and appropriate increase to plant in service when the Company itself failed to provide any evidence that such plant additions exist.

The Company's second symmetry argument does not withstand scrutiny any better than the first one. The Company argues that the accumulated

depreciation related to the Grant Park water system assets should equal the depreciation expense collected in rates by the village of Grant Park. Because the instant proceeding does not contain such evidence, the Company argues Staff's adjustment cannot be accepted. However, the Company's argument conveniently overlooks the fact that not only in the instant proceeding, but also in Docket No. 02-0480, Grant Park's accounting records were devoid of such facts. Mr. Bunosky, of the Company, testified that Grant Park's accounting records were insufficient to determine the net original cost of the system. (Order in Docket No. 02-0480, p. 5) The accumulated depreciation is a key part of determining the net original cost. Because of the inadequacy of the accounting records, Mr. Guastella, the author of the original cost study that determined the entries in Appendix C of the Order in Docket No. 02-0480, testified that he used the following methods to estimate a net original cost of the Grant Park System:

This estimate is based on a determination of the current reproduction cost and a trending of that cost for the year of original installation, along with an adjustment for depreciation to reflect the current condition of the assets. This method required the development of an aged inventory of the assets, a pricing of that inventory using various current cost and construction data, a trend of the current cost back to the original year of installation, and an estimate of the current condition of the assets using the ages of the assets and their relationship to the appropriate average service lives. (Id.) (Emphasis added)

The Company suggests that the Final Order in this proceeding contain the following language:

Grant Park was a troubled company with no reasonable rate of return on its investment or ability to cover fixed costs thus no

depreciation expense was being recovered from customers.
(CIWC BOE, Appendix B, p. 17) (Emphasis added)

Apparently the Company's asymmetry argument does not apply if the Commission declines to adopt Staff's adjustment. There is no evidence that Mr. Guastella's estimate of accumulated depreciation, based upon such factors as current condition of the assets, the ages of the assets, and appropriate average service lives, is synchronized with what the Village of Grant Park collected in rates for depreciation expense, or did not collect per the Company's replacement language cited above. Yet, the Company inconsistently is willing to accept the results of the original cost study regardless of the inability to synchronize the estimated accumulated depreciation and the collection of depreciation expense in rates as of that date.

The PO correctly concludes that "until the transaction actually closed, the acquired system was operated by its former owner, and it continued to depreciate due to its operation." (PO, p. 6) This conclusion is totally complementary to the method described by Mr. Guastella above to determine the net original cost of the Grant Park water system. For this reason, and the reasons cited above, the Company's proposed replacement language for the PO should be rejected.

II. OPERATING REVENUES AND EXPENSES

A. Charitable Contributions

In making a correct conclusion, the PO emphasizes that the Commission is not willing to blur the distinguishable categories of industry dues and charitable contributions. (PO, p. 17) It is this distinction that goes to the heart of the matter.

The Company, in its criticism of the PO, argues essentially that there is no difference between charitable contributions and amounts expended for community and economic development. This is the kind of “blur” that the PO rightly rejects. The Company cites evidence that the amounts in question are for community and economic development in its attempt to redefine them as being for the public welfare.¹ (CIWC BOE, p. 5) The Company, in its direct testimony, identified the amounts in question as “Community & Economic Development” as opposed to “Charitable.” (CIWC Ex. 4.0, Sch. C-7, p. 5 of 5, Column (E)) The Company began its definitional shell game only after Staff took issue with the costs.

The Company also argues that the ALJ ignores the evidence of record in determining that the Company hasn’t shown that the payments are made for the public welfare. (CIWC BOE, p. 5) The Company reiterates the unemployment rate of 7.4% in the city of Kankakee, the number of industrial customers that discussed the shaky Kankakee economy at the public forum, and that its ratepayers benefit from an improved economy from not only more jobs in the

¹ The Company makes the perplexing statement that “Staff did not dispute nor did the record reflect that the contributions shown on Schedule C-7 were made to benefit community and economic development.” (CIWC BOE, p. 5) However Staff reads that to be a misstatement.

area, but the fact that unit costs go down as the costs are spread over a larger customer base. (Id.) Furthermore, the Company would have the Final Order state the following:

The relevant inquiry is whether the contributions to community and economic development organizations in the Kankakee service area are made “for the public welfare.” The Commission finds that they are. While we are unwilling to adopt a broad standard that makes all contributions to community and economic development organizations synonymous to those made “for the public welfare,” we find that the evidence provided in this case reflects that they are. With an unemployment rate of 7.4% and a fragile economy in Kankakee, as testified to in detail at the public hearing on October 29, 2003, certainly contributions to community and economic development organizations in the Kankakee area support “the public welfare” and will benefit all customers. The Staff’s adjustment is denied. (Id., Appendix C, p. 20)

The problem with the Company’s argument and replacement language identified above is that the Company would have the Commission make a finding that Consumer’s payments to community and economic development organizations in Kankakee are unique. The proposed replacement language highlights the fact that the Commission would not find all payments to these types of organizations to be “for the public welfare.” Under the Company’s proposal, the Commission would make a finding that payments to community and economic development organizations in Kankakee are “for the public welfare” because of that city’s less than desirable economy. The Company would, in

essence, have the Commission find that it is the economic conditions of a particular community that determines whether a payment is for goodwill and promotional activity or a charitable donation. However, there is nothing in the record to support this premise. If the Commission believed these types of payments are “for the public welfare” the characterization of the payments should not change depending upon whether a locale had an unemployment rate of 2.4%, or as in Kankakee an unemployment rate of 7.4%.

Additionally, the record contains no evidence that these payments made by the Company have helped alleviate the economic situation in Kankakee or increased the customer base. Furthermore, the Company has not shown that its customers have benefited from these payments. Moreover, the evidence in the record does not support the argument that the ratepayers automatically benefit from an increased customer base. As the customer base grows, the Company benefits from the expanding number of customers while the benefits of a decreasing per unit cost for water would not be passed to the customers until an undetermined future rate case.

The PO amply explains the Commission’s aversion to allowing such payments into the revenue requirement. As explained above, the Company’s arguments to the contrary are not persuasive. Therefore, the Commission should reject the replacement language proposed by the Company.

B. Advertising Expense

The PO, in accepting Staff’s proposed adjustment, recognizes that, “[e]ven if Section 9-225(1)(d) is not directly aimed at CIWC, it demonstrates that the

purpose of goodwill advertising is to improve the image of the utility” and states that this purpose does not fit within the scope of Section 9-227, which is for payments made for the public welfare or scientific, religious, or educational purposes. (PO, p. 20) The PO appropriately emphasizes that, “[a]dvertisements and charitable contributions are different types of transactions, and simply mixing their labels does not support their recovery in rates.” (Id.) Furthermore, the PO suitably states that, “[t]he need to maintain clear and proper accounting records is highly important.” (Id.)

The Company’s proposed replacement language highlights the following arguments: 1) Section 9-225 does not cover water utilities, 2) under Section 9-227 donations must be allowed regardless of intent, and 3) the printing of the Company’s name in a publication does not convert it into advertising. (CIWC BOE, Appendix D, p. 21)

The Company’s first argument, that Section 9-225 does not cover water utilities, is unpersuasive. Section 9-225 doesn’t explicitly mention water utilities but the principles of not charging captive customers for goodwill advertising is equally applicable to water ratepayers. This proposal is consistent with a similar adjustment ordered by the Commission in CIWC’s prior rate case. (Staff Ex. 1.0C, p. 12) The record in this proceeding contains no argument by the Company that the principles of goodwill advertising should not also apply to water utilities. Neither does the Company’s argument in its BOE acknowledge the Commission’s conclusion that goodwill advertising costs are not to be recovered in rates regardless of the lack of specificity to water utilities in Section

9-225. Therefore, the Company's argument that Section 9-225 doesn't apply to water utilities should be given no weight by the Commission.

The Company's second argument, that donations are allowed regardless of the intent of the giver, is irrelevant. The costs at question are not donations, but advertising expenses. As explained in Staff's Reply Brief, the Company is receiving services and benefits from placing these advertisements. (Staff RB, p. 14) This simply is not consistent with the definition of a donation.

The Company's third argument, that the printing of the Company's name in a publication does not convert it into advertising, does not withstand scrutiny. The Company conveniently confuses the nature of the expense. As Staff pointed out in its testimony, the Company records these expenses in an advertising account and the Company refers to these costs in its data request responses and rebuttal testimony as advertising. (Staff Ex. 7.0, p. 13) Staff has not taken issue with the reliability of the Company's accounting system; neither has the Company presented any evidence that the Commission should not rely upon the Company's accounting system. The conversion being attempted is clearly the Company's effort to reclassify some of its advertising expense as charitable donations only for purposes of this rate case. As stated perfectly in the PO, advertising and charitable contributing are not the same, and maintaining clear and proper accounting records is of the utmost importance.

For the reasons stated above, the Commission should give no weight to the Company's arguments and reject the proposed replacement language in its Appendix D.

III. COST OF CAPITAL AND RATE OF RETURN

In its Brief on Exceptions (“BOE”) Consumers Illinois Water Company (“CIWC” or “Company”) criticizes the PO’s conclusions on rate of return and proposes numerous changes for incorporation into the Post Exceptions Proposed Order (“PEPO”). The Company’s BOE focuses on a few issues and largely reiterates the same arguments the Company previously lodged, which Staff has addressed. However, the Company makes several statements that warrant further response. Staff believes that none of the Company’s exceptions to the PO are valid and that none of the changes the Company proposes should be incorporated into the PEPO.

A. COST OF COMMON EQUITY

1. Comparable Earnings

The Company argues that the Commission should revisit its prior position on the Comparable Earning Methodology (“CEM”) presented by Company witness Ahern. However, rather than argue the alleged merits of the CEM, which calculates a utility’s cost of common equity from the accounting earnings of a sample of companies (CIWC BOE, p.7), the Company proceeds to argue that CIWC and IAWC are comparable and thus should have the same authorized ROE. (CIWC BOE, pp.8-9) Specifically, the Company contends that its comparison of the return on equity (“ROE”) granted to Illinois-American Water Company (“IAWC”) in its most recent rate case (Docket 02-0690) and the ROE Staff recommends for CIWC in the present case constitutes a comparable earnings analysis and the Commission should therefore grant CIWC at least the

same return as was granted to IAWC in Docket 02-0690. The Company contends that its comparison to IAWC, a utility in the same industry and state as CIWC, “could not be more closely paralleled” to the criteria stated in the Hope and Bluefield decisions. (CIWC BOE, p. 8) The Company misrepresents a quote on page 8 of its BOE from the 1923 Bluefield decision as also being from the 1944 Hope decision.² (CIWC BOE, p. 8, see Footnote 1) The Bluefield decision held that the return allowed be “equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.” (Bluefield Water Works & Improvement Company v. Public Service Commission of the State of West Virginia, 262 U.S. 67, 1923 *Emphasis added*) IAWC’s last rate case (Docket 02-0690) and the present CIWC rate case did not occur at the same time. (Staff RB, pp.21-22)

Further, the Company’s criticism of the Staff cost of equity analysis for not including a CEM analysis is baseless. The CEM for estimating the return on equity is not equivalent to the comparable risk criterion identified in the Bluefield decision. Staff’s analysis is based on companies of comparable risk to CIWC. (Staff IB, p.25) The Bluefield decision does not specify what type of analyses must be used to determine the rate of return. To the contrary, in the later Duquesne Light Company decision, the Court stated “the [Pennsylvania]

² The Company fails to cite any language in Hope at all, let alone anything that supports its argument. The Hope decision states “the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.” *Emphasis added*. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

Commission was not bound by the use of any single formula or combination of formulae in determining rates.” (Duquesne Light Co. v. Barasch, No. 87-1160, 488 U.S. 299, January 11, 1989.)

The Company asserts that “[t]here is nothing in the record that explains a 41 basis point difference in rate of return on common equity” between Docket 02-0690 and the present case. (CIWC BOE, p. 8) The Company’s argument is wholly without merit. While the record does not contain the details behind the authorized ROE for IAWC,³ the Order in Docket 02-0690 was sufficiently detailed for Staff to explain the difference between the ROE granted in Docket 02-0690 and the ROE Staff recommends for CIWC in the present case. (See Staff RB, pp. 19-22) In addition, the Company’s argument that Staff’s ROE models are flawed and that an average of estimates over time should be used would have the Commission ignore eight months of declining equity costs. (CIWC BOE, p. 9) The Commission should not ignore eight months of declining equity costs, just as the Commission did not ignore rising equity cost between CIWC’s 1998 and 1999 rate cases. (Staff RB, p. 22) Either result would be unreasonable; and would have the potential to lead to biased authorized rates of return. Staff is unaware of any dockets in which a utility or Staff argued that the Commission should ignore rising equity costs.

³ It seems that CIWC forgets that only its proposed tariffs are the subject of this proceeding. Hence, Staff correctly presented only the analyses it performed in development of its recommended ROE for CIWC. Nevertheless, Staff also showed that the cost of equity analyses it performed in this proceeding are consistent with those performed in Docket No. 02-0690 concerning IAWC’s most recent general rate increase. (Staff RB pp. 19-21)

2. Empirical CAPM

The Company argues that its empirical CAPM requires the use of adjusted betas. (CIWC BOE, p. 10) Staff fully addressed why using adjusted betas in the Company's empirical CAPM is inappropriate in Staff's Initial Brief. (Staff IB, pp. 31-32) In addition, the Company' proposed language does not adopt the arguments it made regarding the use of its empirical CAPM on pages 9-10 of its BOE. (CIWC BOE, Appendix G p. 26)

3. Business Risk Adjustment

The Company contends that it deserves a business risk adjustment based on its small size. (CIWC BOE, p. 11) Staff fully addressed this issue in its Initial Brief. (Staff IB, pp.36-37) The Company argues that its expected expenditures in 2003 demonstrate how significant capital expenditures increase the risk for small companies. (CIWC BOE, p. 14). However, the Company presents only raw figures. The Company fails to provide any information that showed that its expenditures relative to its size is proportionally greater than those of the companies Staff used to determine its cost of equity recommendation. Obviously, a \$100 million company can more easily finance \$10 million in capital expenditures than a \$10 million company. Without showing that CIWC spends a larger portion on expenditures compared to its size than the companies in Staff's samples, CIWC cannot support its assertion that it deserves any business risk adjustment, let alone a 90 basis point adjustment it seeks, but does not explain,

in its proposed language.⁴ (CIWC BOE, Appendix G p. 28) Thus, the Company's proposed adjustment for business risk, whether it be as many as 90 basis points or as few as 25, is wholly without merit and should be ignored.

Finally, the Company challenges Ms. Kight's use of a credit rating of A+ for CIWC instead of its NAIC-2 rating associated with three of the Company's debt issues. The appropriateness of NAIC ratings was fully addressed by Staff in its Reply Brief. (Staff RB, pp. 22-24) Nevertheless, the Company's statement that insurance companies are members of the NAIC (CIWC BOE, p. 15) needs to be corrected. Only insurance regulators are members of the NAIC. (Tr. P. 181).

IV. CONCLUSION

For the foregoing reasons, the Staff of the Illinois Commerce Commission respectfully requests that the Commission order reflect Staff's recommendations.

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Respectfully submitted,



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⁴ The Company witness made a business risk adjustment of only 25 and 35 basis points to her equity recommendation. (CIWC BOE p. 11)

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